

An opportunity for Luxembourg funds: Improvement of the tax treatment for individual investors of foreign funds marketed in France

May 25, 2007

Over the past two years, French law has developed and adapted to the EU environment, resulting in new opportunities for foreign funds. Basically, UCITS funds located in another Member State of the European Union, regardless of whether these funds are contractual or corporate structures, can now distribute their income to French individual investors, affording them the same tax benefits as a French UCITS.

As a preliminary remark, the following comments do not address the case of institutional investors. As far as they are concerned, the tax impacts of investing in a French fund or a foreign fund are comparable. Similarly, for individual investors, the tax treatment of capital gains has been aligned for several years. Just as for French funds, capital gains arising on the sale of units/shares of foreign funds are taxable in the hands of French individual investors at a fixed rate of 27%. Capital gains are only taxed if the investor sold securities in an amount exceeding EUR 20,000 in the year.

The tax treatment of income distributions to French individual investors has been almost entirely harmonised.

Dividend income

The first set of rules relates to dividend distributions: further to the abolition of the “avoir fiscal”, dividend taxation has been entirely revisited. Since 2006, French individuals receiving dividend income have been granted a 40% allowance on the taxable basis; tax is levied on the remaining 60% at the progressive income tax rate. This allowance also applies to dividends cashed by a French individual through a fund. The law provides the same benefits for French and foreign funds as long as certain requirements are met.

First, the dividend must originate from a qualifying distribution, i.e. a distribution made by a corporation located in a EU country or a country having a tax treaty with France, which includes an administrative assistance clause. In addition, the distribution has to be decided on by the relevant body of the corporation and the corporation must be in the scope of corporate income tax. While the first aspect is usually easy to verify based on market data, the second raises more practical difficulties. In order to resolve this issue, French lawmakers have imposed reporting obligations on French issuers who shall provide the relevant information in the legal documentation held for the annual shareholders' meeting. However, the issue remains for distributions cashed by the fund from a non-French distributing company.

The fund shall split its distribution, i.e. it must specifically identify a dividend coupon, which corresponds to the redistribution of qualifying dividends with the benefit of the 40% allowance.

Additional constraints are imposed on the fund itself and the fund manager. The main constraint is the obligation imposed on the fund to isolate in its accounting books the dividend flows which it cashes and which are considered qualifying distributions for the purposes of granting the 40% allowance. The partition shall be reported accordingly in the annual or semi-annual report of the fund. There is also an obligation for the manager to report this information to the paying agent.

Although these are mainly administrative and reporting conditions, current experience shows that French funds have included such obligations in their internal set up for years and therefore are able to claim some competitive advantage in this field.

Interest income

Under French tax law, interest income is taxed at a progressive income tax rate. However, when receiving interest payments from bonds, negotiable securities and loans¹, French individuals may elect to be taxed on these payments immediately by way of withholding at a fixed rate of 27%.

For years, French funds, whether SICAVs or FCPs, have been authorized to reallocate interest income to their individual investors with the benefit of this favourable taxation regime by splitting their distribution and identifying the corresponding “interest coupon”.

In 2005, the fixed rate regime was made available to interest income paid from a foreign source. Details of the regime have been set in a tax regulation issued on 16 October 2006. As a result, interest coupons allocated by a foreign fund to French resident individuals can benefit from this regime.

Two situations may be considered:

If the client has opened an account with a French paying agent and receives the interest payment from the latter, the withholding tax and remittance process is exactly the same as for interest paid from a French fund.

As a result, the favourable taxation rate can easily apply, provided the following conditions are met:

1. The foreign fund is a UCITS under Directive 85/611 EC or a similar fund established in a Member State of the EEA which benefits from the mutual recognition for being commercialized in France;
2. The interest income falling in the scope of the fixed rate taxation is paid as a specific coupon (split coupon).

On the other hand, if the client has opened an account with a financial institution abroad, the regime turns out to be more difficult to use and implement. Again, the French individual may elect the fixed rate taxation when receiving the income. However in this case, he is legally liable for submitting a return and remitting the tax to the French revenue. Under the regulation, the client may also mandate the foreign financial institution to liaise with the tax revenue. Further, foreign paying agents with a significant number of French clients may request signing a specific agreement with the French tax authorities whereby, provided they levy the tax pursuant to a

¹ Subject to conditions.

mandate from French clients, they are authorized to file the tax return and remit the amount globally rather than for each client separately.

The regulation does not comment specifically on the obligations imposed on a foreign fund in this second case. In particular, it is not stated that the fund shall be authorized for distribution in France. As a result, it should apply to both UCITS and non-UCITS funds.

These changes could significantly improve the competitiveness of foreign and Luxembourg funds marketed in France, as they will put them on a level playing field with French funds. However, investment managers will have to fulfil certain conditions before individual investors can receive the most advantageous tax treatment.

From an operational standpoint, this will require a complete review of securities master, the classification of revenues generated by the assets in the fund accounting system and the development of a proper reporting.

PricewaterhouseCoopers has a dedicated team of tax and advisory specialists who can assist in respect of the implementation of these new rules. Should you need any assistance in that respect feel free to contact the people listed below.

Contacts

If you would like further advice in relation to the issues outlined above, please call your local PricewaterhouseCoopers contact or alternatively any of the people listed below:

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